



1985

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Recommended Citation

Wm. D. Elliott, *The Tax Benefit Rule: A Common Law of Recapture*, 39 Sw L.J. 845 (1985)
<https://scholar.smu.edu/smulr/vol39/iss4/2>

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THE TAX BENEFIT RULE: A COMMON LAW OF RECAPTURE

by

Wm. D. Elliott *

Our federal income tax accounting system is based upon the tax year. The tax effects of transactions, though, are frequently unconfined to the artificial and rigid boundaries of that period. Events of earlier years can affect the amount or character of both subsequent income and deductions. The tax benefit rule is a term that loosely describes the judicial, administrative, and legislative doctrine of accounting for events covering two or more tax years.

A hallmark of modern tax reform is to achieve a rough, if not precise, transactional parity. The Tax Reform Act of 1984 contained numerous provisions designed to tax consistently different parts of the same transaction occurring in different tax years.¹ These provisions descend from the tax benefit rule. Thus, what began as a minor tax accounting concept one-half century ago has grown into a significant analytical tool for the Internal Revenue Service. The tax benefit rule now provides the IRS with a major enforcement weapon in its unceasing efforts to achieve perfect transactional parity. The potential of this old, but ever-expanding weapon appears limitless.

The events that propelled the tax benefit rule into the IRS's heavy-duty arsenal occurred in 1983 when the Supreme Court decided *Hillsboro National Bank v. Commissioner*,² which was a consolidation of the companion cases of *Hillsboro National Bank* and *United States v. Bliss Dairy, Inc.*³ With this decision the IRS departed from the old, rigid concepts that had marked the tax benefit rule since the rule's inception. The Court paved the way for this departure by providing the IRS with authority for a new approach, the

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1. The Tax Reform Act of 1984, Pub. L. No. 98-369, 98 Stat. 494, enacted or revised the following: I.R.C. § 267(a)(2) (West Supp. 1985) (matching requirements on transactions between related parties); *id.* § 461(h) (all events accrual deduction delayed until economic performance); *id.* § 467 (recapture of excluded rental income); *id.* §§ 1271-1275 (West 1982 & Supp. 1985) (original issue discount rules expanded).

2. 460 U.S. 370 (1983).

3. *Id.* In this Article the style *Hillsboro National Bank v. Commissioner* will be used when referring to the general principles enunciated in that decision and the styles *Hillsboro National Bank* or *Bliss Dairy* will be used when referring to particular facts or legal principles pertaining to those specific cases.

"fundamentally inconsistent" test.⁴ Failure to understand and appreciate the significance of this new test could imperil the expected tax results of carefully planned transactions. The burden on taxpayers, therefore, has become even more unrelenting because of the new tax benefit rule, a common law of recapture.

I. THE TAX BENEFIT RULE

A. Inclusion in Income

Originally, the tax benefit rule generally provided that if an amount deducted in one year was recovered in a later year, the recovery constituted income in the subsequent year.⁵ Congress modified the rule to provide that if the earlier deduction did not reduce income tax liability, the taxpayer could exclude the later recovery of the item from income.⁶ The general rule is commonly called the rule of inclusion, and the statutory modification is commonly called the rule of exclusion. Together, they constitute the tax benefit rule.⁷

The tax benefit rule applies not only to recoveries in a strict sense, but also to situations involving increments to net worth.⁸ For example, the tax benefit rule applied when a seller reimbursed a buyer for interest that the buyer had prepaid and previously deducted.⁹ The rule also applied when a taxpayer terminated a previously deducted accrued liability.¹⁰ Moreover, the rule applied when a parent corporation that previously had deducted its worthless investment in a subsidiary later used that subsidiary's net operating losses to shield the income of a profitable business that the parent had

4. *Id.* at 372, 383-84.

5. 1 B. BITTKER, *FEDERAL TAXATION OF INCOME, ESTATES, AND GIFTS* ¶ 5.7 (1981). At its inception the tax benefit rule concerned the recoveries of bad debts that taxpayers had previously deducted. In 1922 the Treasury Department concluded that the recovery of a previously deducted debt constituted income. Treas. Reg. 62, art. 51, T.D. 3295, 24 Treas. Dec. Int. Rev. 230-31 (1922). Later the Treasury Department applied the extreme rule that the subsequent recovery of a bad debt was taxable whether or not the taxpayer actually took a deduction, so long as that deduction was allowable. S.R. 2940, IV-1 C.B. 129 (1925). Gradually, the Treasury Department's stance shifted to the more moderate position that the later recovery of a previously deducted bad debt was taxable only if the earlier deduction had caused a reduction in taxable income. G.C.M. 20854, 1939-1 C.B. 76.

6. Revenue Act of 1942, Pub. L. No. 77-753, § 116, 56 Stat. 798, 812-13.

7. In discussing the widespread nature of the tax benefit rule, the Tax Court stated:

The tax benefit rule is both a rule of inclusion and exclusion: recovery of an item previously deducted must be *included* in income; that portion of the recovery not resulting in a prior tax benefit is *excluded*. The rule in both aspects evolved judicially and administratively. The rule has been codified as to certain items in sec. 111. While focusing on the second aspect (exclusion), sec. 111 is predicated on the validity of the first aspect (inclusion). Although the rule has been partly absorbed in the statute, it has been expressly stated that the unabsorbed portion of the rule continues to apply.

Putoma Corp. v. Commissioner, 66 T.C. 652, 664 n.10 (1976) (emphasis in original), *aff'd*, 601 F.2d 734 (5th Cir. 1979).

8. See Bittker & Kanner, *The Tax Benefit Rule*, 26 UCLA L. REV. 265, 272 n.23 (1978).

9. Weyher v. Commissioner, 66 T.C. 825, 829 (1976).

10. Bear Mfg. Co. v. United States, 430 F.2d 152, 154 (7th Cir. 1970); Mayfair Minerals, Inc. v. Commissioner, 56 T.C. 82, 88-94 (1971), *aff'd per curiam*, 456 F.2d 622 (5th Cir. 1972).

merged into the subsidiary.¹¹ Recovery of previously omitted income also invokes the tax benefit rule. For example, when a taxpayer failed to include funds embezzled from it in income, the court held that the taxpayer should include in income the later recovery of those funds.¹²

In some cases tax allowances or credits can trigger the tax benefit rule. For example, a court held that receipts from sales of securities, following a securities inventory write-down, were fully includable in income because of the rule.¹³ Moreover, courts have been indifferent that, because of bracket rate differentials, taxing a recovery of an earlier deduction in the current year would not achieve a precise recapture of the earlier tax benefit.¹⁴ The foregoing examples demonstrate that the inclusionary component of the tax benefit rule is an elastic concept that courts apply in a wide variety of situations.¹⁵

B. Exclusion from Income

The second part of the tax benefit rule is the exclusionary aspect, which is codified in Internal Revenue Code section 111.¹⁶ The rule of exclusion generally provides that the later recovery of a deducted item is excluded from income if the earlier deduction did not result in any tax benefit. Congress first enacted section 111 in 1942¹⁷ in an attempt to clarify confusion that judicial decisions had created.¹⁸ In the Tax Reform Act of 1984, Congress rewrote section 111 and substantially reduced that section's exclusionary role.¹⁹

The new section 111 provides an exclusion from gross income for recoveries "during the taxable year of any amount deducted in any prior taxable

11. *Textron, Inc. v. United States*, 561 F.2d 1023, 1027 (1st Cir. 1977).

12. *Keystone Nat'l Bank v. United States*, 57-2 U.S.T.C. ¶ 9773 (W.D. Pa. 1957). Similarly, recovery of charitable contributions can invoke the tax benefit rule. In Rev. Rul. 76-150, 1976-1 C.B. 38, the IRS ruled that charitable contributions recovered by a taxpayer were includable in income in the year of recovery, although a subsequent contribution to another charity qualified as a charitable contribution.

13. *Union Trust Co. v. United States*, 173 F.2d 54, 56 (7th Cir.), *cert. denied*, 337 U.S. 940 (1949).

14. 1 B. BITTKER, *supra* note 5, ¶ 5.7.1, at 5-48. The Court of Claims tried an exact matching of tax brackets. *Perry v. United States*, 160 F. Supp. 270, 272 (Ct. Cl. 1958). The Court of Claims, however, later abandoned that idea. *Alice Phelan Sullivan Corp. v. United States*, 381 F.2d 399, 402 (Ct. Cl. 1967); see Bittker & Kanner, *supra* note 8, at 270 n.17.

15. For other applications of the inclusionary aspect of the tax benefit rule, see: *Schultz v. United States*, 79-1 U.S.T.C. ¶ 9199 (E.D. Wis.) (state income tax refund), *aff'd mem.*, 624 F.2d 1103 (7th Cir. 1979); *Roxy Custom Clothes Corp. v. United States*, 171 F. Supp. 851, 853-54 (Ct. Cl. 1959) (termination of previously accrued and deducted liability); *Lime Cola Co. v. Commissioner*, 22 T.C. 593, 601-02 (1954) (termination of previously accrued and deducted liability); Rev. Rul. 71-161, 1971-1 C.B. 76 (casualty loss); Rev. Rul. 71-160, 1971-1 C.B. 75 (casualty loss); 1 J. MERTENS, *THE LAW OF FEDERAL INCOME TAXATION* § 7.35 (J. Doheny ed., rev. ed. 1981) (prior deduction of bad debt).

16. I.R.C. § 111 (West Supp. 1985).

17. Revenue Act of 1942, Pub. L. No. 77-753, § 116, 56 Stat. 798, 812-13.

18. See H.R. REP. NO. 2333, 77th Cong., 2d Sess. 45 (1942). The Internal Revenue Code of 1954 enacted the prior provision without any substantive change. 1 J. MERTENS, *supra* note 15, § 7.34, at 117 n.1.

19. H.R. REP. NO. 432, 98th Cong., 2d Sess. 1368, *reprinted in* 1984 U.S. CODE CONG. & AD. NEWS 697, 1015.

year to the extent such amount did not reduce income subject to tax."²⁰ In contrast, old section 111 excluded from income recoveries of bad debts, prior taxes, or delinquency amounts to the extent that the earlier deduction was of no tax benefit.²¹ The regulations under old section 111 further extended that section to "all other losses, expenditures, and accruals made the basis of deductions," except for depreciation, depletion, or amortization.²² Since the new section 111 covers the recovery of any amount deducted, the new section 111 appears to codify the all-inclusive coverage of the old section 111 and that section's regulations.²³

New section 111 provides that an exclusion from income for a later recovery exists only to the extent that the prior item did not reduce income subject to tax.²⁴ Under old section 111 the exclusion from income was limited to the "amount . . . which did not result in a reduction of the taxpayer's tax . . . reduced by the amount excludable in previous taxable years with respect to such [item]."²⁵ New section 111 reverses the order of recovery of the previously deducted item.²⁶ Congress reported that a taxpayer should be put in the same after-tax position as if he had deducted the proper amount.²⁷ Congress objected to old section 111 because the section assumed that a taxpayer first recovered that part of the prior deduction that did not reduce taxable income.²⁸ Congress believed that a taxpayer reaped a windfall if the law assumed that the first dollars he recovered were not the dollars that produced the tax benefit.²⁹

Example: Under old section 111 taxpayer had a \$1,000 deduction attributable to a section 111 item, but only \$900 of excess itemized deductions, so \$100 of the deduction for the section 111 item had no effect. During the following year taxpayer recovered \$150 of the section 111 item.³⁰

The old section 111, as illustrated below, assumed that the part³¹ of the section 111 item recovered first was the part that did not produce a tax benefit. The new section 111 reverses this order of recovery. Under new section 111 the taxpayer first recovers the part of the section 111 item producing a tax benefit and recognizes this part in income; the taxpayer then recovers the part not producing a tax benefit and excludes this part from income. In the above example, new section 111 requires that the taxpayer include in income

20. I.R.C. § 111(a) (West Supp. 1985).

21. *Id.* § 111(a) (1982) (amended 1984).

22. Treas. Reg. § 1.111-1(a) (1960).

23. Congress did not, when rewriting section 111, intend to change or alter either the tax benefit rule's scope or the meaning of a recovery. STAFF OF THE JOINT COMM. ON TAXATION, GENERAL EXPLANATION OF THE REVENUE PROVISIONS OF THE DEFICIT REDUCTION ACT OF 1984, at 522 (1984).

24. I.R.C. § 111(a) (West Supp. 1985).

25. *Id.* § 111(b)(4) (1982) (amended 1984).

26. H.R. REP. NO. 432, 98th Cong., 2d Sess. 1368-69, reprinted in 1984 U.S. CODE CONG. & AD. NEWS 697, 1015-17.

27. *Id.* at 1368, 1984 U.S. CODE CONG. & AD. NEWS at 1015-16.

28. *Id.*

29. *Id.* at 1368-69, 1984 U.S. CODE CONG. & AD. NEWS at 1015-17.

30. See 1 B. BITTKER, *supra* note 5, ¶ 5.7.3.

31. The analysis is the same if the taxpayer has more than one § 111 item.

	Return as Filed (with deduction of section 111 item)	Recomputation of Return (without deduction of section 111 item)
Gross Income	\$15,000	\$15,000
Less:		
Section 111 item	900	
Zero bracket amount	2,300	2,300
Personal exception	1,000	1,000
Taxable Income	<u>\$10,800</u>	<u>\$11,700</u>
Section 111 item		\$ 1,000
Increase in taxable income due to excluding section 111 item		<u>900</u>
Recovery Exclusion		<u>\$ 100</u>
Recovery Included in Income		<u>\$ 50</u>

the first \$900 of the section 111 item recovered in the later year, and the taxpayer may exclude only the last \$100 recovered.

The tax benefit rule applies to credits as well as deductions. If the amount recovered relates to a credit claim in a prior year, the tax is increased by the amount of the recovered credit, but only to the extent that the prior credit actually reduced the amount of the prior year's tax.

Example: Under new section 111 the taxpayer spent \$2,000 on storm windows and claimed a 15% energy conservation credit of \$300. The following year the manufacturer rebated \$400. The taxpayer's tax in the following year is therefore increased by \$60 (15% x \$400).³²

The new section 111, however, does not apply to recoveries on which the taxpayer previously recognized an investment tax credit or a foreign tax credit because existing law already covers those recoveries.³³ Moreover, the section provides that an increase in a carryover amount reduces the amount of tax.³⁴ When computing accumulated earnings tax³⁵ or personal holding company tax,³⁶ the new law allows any exclusion permitted under section 111, even if the prior deduction reduced the accumulated earnings tax or personal holding company tax of the prior year.³⁷ If the prior deduction was not deductible when computing the regular income tax, however, the section 111 exclusion from regular income is allowed only to the extent that the

32. When the deduction occurred under old § 111, but the recovery occurs under new § 111, the new rule should be applied. The rule is a rule of exclusion, hence the rule is applied in the year when the taxpayer seeks the exclusion.

33. I.R.C. § 111(b)(3) (West Supp. 1985).

34. *Id.* § 111(c).

35. *Id.* § 531 (1982).

36. *Id.* § 541.

37. *Id.* § 111(d)(1) (West Supp. 1985).

prior deduction did not reduce the prior year's accumulated earnings tax or personal holding company tax.³⁸ A partial reduction of the accumulated earnings tax or the personal holding company tax causes the later recovery to be taxable to that extent since the recovered amount is presumed to have been deducted first.

Example: Federal income tax is not deductible when computing regular income tax liability, but is deductible when computing accumulated earnings tax and personal holding company tax. A refund of federal income tax, therefore, is includible in income if the deduction of the refunded amount had previously reduced the accumulated earnings tax or the personal holding company tax.

II. VARIATIONS OF THE TAX BENEFIT RULE

A. Reverse Tax Benefit³⁹

The tax benefit rule operates in reverse when the taxpayer refunds amounts that he previously included in income. Section 1341⁴⁰ allows the taxpayer to compute the tax effect of the repayment under a special method. In the repayment year, the taxpayer pays the lesser of: (1) income tax computed by deducting the repaid amount from taxable income; or (2) income tax, computed without deducting the repaid amount from taxable income, but reduced by the attributable tax detriment the taxpayer suffered in the year he included the repaid item in taxable income.⁴¹ This methodology ensures that the tax savings resulting from the later deduction is comparable to the earlier tax paid.⁴²

In *United States v. Skelly Oil Co.*⁴³ the Supreme Court held that Skelly Oil, which was required to return to customers money that it had previously included in income, could deduct that repayment only if it applied percentage depletion to the repayment since it had applied percentage depletion to the prior income.⁴⁴ The favorable tax treatment given the earlier receipts limited the deduction in the subsequent year.⁴⁵ Although courts have not broadly applied the reverse tax benefit rule, the Supreme Court decision in *Skelly Oil* suggests a significant application for the rule. Congress did not intend to give taxpayers a deduction when they refunded money that they had not included in income when received.⁴⁶

38. *Id.* § 111(d)(2).

39. The phrase "reverse tax benefit" apparently originated in Bittker & Kanner, *supra* note 8, at 281.

40. I.R.C. § 1341 (1982).

41. *Id.*

42. In *O'Meara v. Commissioner*, 8 T.C. 622, 632-35 (1947), *acq.* 1947-2 C.B. 3, the IRS argued that no deduction for refunds should exist when the inclusion of those items in the previous year of receipt "brought the Government no tax benefit." 8 T.C. at 632.

43. 394 U.S. 678 (1969).

44. *Id.* at 683-86.

45. Rabinovitz, *Effect of Prior Year's Transactions on Federal Income Tax Consequences of Current Receipts or Payments*, 28 TAX L. REV. 85, 86 (1972).

46. 1 B. BITTKER, *supra* note 5, ¶ 5.7.4; Bittker & Kanner, *supra* note 8, at 282.

B. Quasi-Estoppel and the Unvert Doctrine

Rigid dedication to the annual accounting concept can lead to absurd results. For example, if the statute of limitations barred review of a year in which the taxpayer had deducted an item that he subsequently recovered, the taxpayer could argue that the later recovery should not be deemed to have resulted in a tax benefit and should therefore not constitute income.⁴⁷ In the tax benefit rule's early years the rule did not adequately deal with the statute of limitations' closing of earlier deduction years. In *Streckfus Steamers, Inc. v. Commissioner*⁴⁸ the Tax Court held that the tax benefit rule applied only when the deduction in the earlier year was properly taken.⁴⁹ In that case the taxpayer erroneously deducted an Illinois sales tax in 1940. In 1943 an Illinois state court declared that the taxpayer was not liable for the tax. The IRS argued that the taxpayer realized income in 1943 when it recovered the sales tax because the earlier deduction of the sales tax gave the taxpayer a tax benefit. The Tax Court, however, held the tax benefit rule inapplicable.⁵⁰ A prior year's erroneous deduction could not be income in a later year.⁵¹ Accordingly, the tax benefit rule did not apply even though the statute of limitations barred correction of the erroneous deduction. The Tax Court later softened the *Streckfus Steamers* rule in *Mayfair Minerals, Inc. v. Commissioner*.⁵² In that case the court held that a taxpayer could not hide behind the statute of limitations when it had misled the IRS and the IRS had consequently allowed the statute of limitations to run.⁵³

In *Unvert v. Commissioner*⁵⁴ the Tax Court crystalized its position and tolled the death knell of the *Streckfus Steamers* doctrine. In that case the taxpayer prepaid interest on his future purchase of condominium units. The taxpayer deducted the prepaid interest when he filed his return, believing that the prepaid interest deduction was proper. Subsequently, the seller informed the taxpayer that he would not complete the sale of the condominium units. The taxpayer then obtained a refund of his prepaid interest.

The IRS subsequently audited the taxpayer. The audit began when the statute of limitations for the year of the aborted condominium purchase had

47. In *Burnet v. Sanford & Brooks Co.*, 282 U.S. 359 (1931), the taxpayer experienced net operating losses for three years, but in a later year recovered those losses in a lawsuit. The Supreme Court denied the taxpayer the alternative of including the receipt in amended returns for the loss years and held that the recovery of the previously deducted losses should be income in the year of the recovery. *Id.* at 362-63; *accord* *H.W. Nelson Co. v. United States*, 308 F.2d 950, 955-56 (Ct. Cl. 1962). The harshness of the annual accounting concept led to the wrong result and also led to the tax benefit rule.

48. 19 T.C. 1 (1952), *nonacq.* 1981-2 C.B. 3.

49. 19 T.C. at 8-9; *see also* *Commissioner v. Schuyler*, 196 F.2d 85, 87 (2d Cir. 1952) (deduction erroneously taken in prior year not taxable in later year).

50. 19 T.C. at 8-9.

51. *Id.*

52. 56 T.C. 82 (1971), *aff'd per curiam*, 456 F.2d 622 (5th Cir. 1972); *see also* Rev. Rul. 77-79, 1977-1 C.B. 34 (corporation recovering previously deducted state taxes paid under protest was taxed on the recovery, at least to extent of the incremental percentage depletion of the year of payment).

53. 56 T.C. at 91.

54. 72 T.C. 807 (1979), *aff'd*, 656 F.2d 483 (9th Cir. 1981), *cert. denied*, 456 U.S. 961 (1982).

not yet run. During the audit the IRS requested certain information from the taxpayer concerning the condominium, but the taxpayer did not respond. After several unanswered subsequent requests, the statute of limitations on the purchase year ran. The IRS, though, later obtained the requested information through other channels.

The IRS argued that the recovery of the prepaid interest should be taxable based on the tax benefit rule. The taxpayer, on the other hand, argued that the tax benefit rule did not apply because of the erroneous deduction exception of *Streckfus Steamers*. Notwithstanding the fact that the taxpayer genuinely believed that he owned the condominium property when he filed his return, the Tax Court held the taxpayer responsible for his misleading silence during the audit.⁵⁵ The court concluded that a duty of consistency precludes a taxpayer who received a tax benefit in a prior year that is now barred by the statute of limitations from claiming that the deduction was improper.⁵⁶ Although the Tax Court did not expressly overrule *Streckfus Steamers*, little doubt exists that the *Unvert* case represents the end of the erroneous deduction exception to the tax benefit rule. A taxpayer who now attempts to gain the tax benefit rule's protection by running the statute of limitations will most likely fail.⁵⁷

III. THE WATERSHED: *HILLSBORO NATIONAL BANK* AND *BLISS DAIRY*

Unquestionably, the single most important development in the tax benefit rule since the 1942 enactment of section 111 is the 1983 Supreme Court decision in *Hillsboro National Bank v. Commissioner*,⁵⁸ which consists of the companion cases of *Hillsboro National Bank* and *Bliss Dairy*. The Court's reformulation of the tax benefit rule in that decision has ushered in a new era for the rule. All future transactions must now be measured against the Supreme Court's new test.

A. The Cases

In *Hillsboro National Bank* the Supreme Court applied the tax benefit rule to a refund of property taxes paid to shareholders of an Illinois bank. In that case Hillsboro National Bank paid and deducted Illinois property taxes imposed on the bank's shares. In 1970 Illinois amended its constitution to prohibit such taxes. The Illinois Supreme Court, however, held the amendment unconstitutional⁵⁹ and the Illinois legislature passed a statute requiring the collection and deposit into escrow of the disputed taxes. In 1973 the Supreme Court upheld the state constitutional amendment,⁶⁰ which prohib-

55. 72 T.C. at 818.

56. *Id.* at 814-15.

57. For contemporary applications of *Unvert*, see: Rev. Rul. 81-207, 1981-2 C.B. 57 (embezzled funds previously deducted as purchases); Ltr. Rul. 8344003 (July 14, 1983) (basis in GNMA certificates).

58. 460 U.S. 370 (1983).

59. *Lake Shore Auto Parts Co. v. Korzen*, 49 Ill. 2d 137, 273 N.E.2d 592, 599 (1971), *rev'd sub nom. Lehnhausen v. Lake Shore Auto Parts Co.*, 410 U.S. 356 (1973).

60. *Lehnhausen v. Lake Shore Auto Parts Co.*, 410 U.S. 356, 365 (1973).

ited the taxes, and Illinois refunded the taxes paid to the bank's shareholders. The bank had deducted its payment of the taxes in 1972 pursuant to Code section 164(e).⁶¹ The bank, however, did not report any income when Illinois refunded the taxes to the shareholders in 1973. The IRS asserted a deficiency against the bank based upon the bank's failure to include in income the tax refunded to the shareholders. The bank argued that since the shareholders, and not the bank, received the refund, the tax benefit rule did not apply. The Tax Court held that the tax refund was income to Hillsboro National Bank, and the Seventh Circuit affirmed.⁶²

In *Bliss Dairy* the taxpayer was in the dairy business. For the tax year ending June 30, 1973, Bliss Dairy deducted approximately \$150,000 for cattle feed expenses. During the next tax year Bliss Dairy adopted a plan of liquidation and distributed its assets to its shareholders. The distributed assets included \$56,000 worth of the cattle feed that Bliss Dairy had deducted in the preceding tax year. Bliss Dairy, relying on section 336,⁶³ reported no income on the distribution of the previously deducted cattle feed. On the other end of the distribution, Bliss Dairy's shareholders filed a section 333⁶⁴ election and also did not recognize any income. The shareholders then continued to operate the dairy in a noncorporate form. Pursuant to section 334(c),⁶⁵ the shareholders presumably allocated part of their basis in the redeemed stock to the cattle feed. Subsequently, the shareholders presumably deducted that basis as a business expense. The IRS claimed that the tax benefit rule required Bliss Dairy to include in income the value of the unused feed that it had distributed. Bliss Dairy paid the asserted deficiency and brought a refund suit, asserting that the distribution was not a recovery within the purview of the tax benefit rule. Bliss Dairy prevailed in the lower court, and the Ninth Circuit affirmed.⁶⁶

The taxpayers argued in both cases that the tax benefit rule only required taxpayers to report income in later years following a recovery of a previously deducted item.⁶⁷ In both cases the requisite recovery was missing. Neither taxpayer corporation recovered anything. The IRS, therefore, pressed for abandonment of the recovery requirement. The IRS asserted that the tax benefit rule required a taxpayer to recognize as income amounts previously deducted if later events were inconsistent with that earlier deduction.⁶⁸ The recovery of previously deducted taxes on bank shares and the distribution of unused cattle feed to shareholders in liquidation were inconsistent with the previous deductions. Accordingly, the IRS argued that both taxpayers should recognize income.

The Court stated that the annual accounting system was a practical neces-

61. I.R.C. § 164(e) (1982).

62. 73 T.C. 61, 66-68 (1979), *aff'd*, 641 F.2d 529 (7th Cir. 1981).

63. I.R.C. § 336 (1982).

64. *Id.* § 333.

65. *Id.* § 334(c).

66. 645 F.2d 19, 20 (9th Cir. 1981) (the district court decision was unreported).

67. 460 U.S. at 381.

68. *Id.*

sity to the income tax system, but the Court believed that strict adherence to the annual accounting system produced transactional inequities.⁶⁹ The Court perceived the tax benefit rule's purpose as approximating the tax results that the taxpayer would achieve if it used a transactional rather than annual accounting system.⁷⁰ The tax benefit rule was designed to achieve transactional parity while protecting both the IRS and the taxpayer from the adverse effects of reporting a transaction based on what later prove to be erroneous assumptions.⁷¹ The rule eliminated distortions that might otherwise arise in an annual accounting system.⁷²

The Court did not agree completely with either the IRS's or the taxpayers' arguments. The Court believed that the tax benefit rule was designed to tax more than recoveries and that requiring a recovery would introduce an undesirable formalism into the rule's application.⁷³ The Court found that lower courts had stretched the meaning of recovery to the point that the tax benefit rule covered many situations that might not even be recoveries.⁷⁴ For example, the Court cited *Tennessee-Carolina Transportation, Inc. v. Commissioner*.⁷⁵ In that case the taxpayer distributed previously expensed assets in liquidation. The lower court applied the tax benefit rule and concluded that a recovery existed in a practical, even though not in a technical, sense.⁷⁶

The Court stated that not every unforeseen event will cancel an earlier deduction.⁷⁷ The Court concluded that the tax benefit rule cancelled an earlier deduction only when the later event was fundamentally inconsistent with that deduction.⁷⁸ Consequently, a court should invoke the tax benefit rule whenever the subsequent event would have foreclosed the deduction if that event and the deduction had occurred in the same tax year.⁷⁹ The Court no longer required a recovery.⁸⁰ The tax benefit rule now consisted of the fundamentally inconsistent test.⁸¹

Although an inconsistent event invokes the tax benefit rule, an unexpected event does not.⁸² The Court illustrated the distinction between inconsistent and unexpected events with the following example. If a taxpayer properly expensed rent attributable to year two in year one, and a fire then destroyed

69. *Id.* at 377.

70. *Id.* at 381.

71. *Id.* at 383.

72. *Id.* at 389.

73. *Id.* at 381-82.

74. *Id.* at 382.

75. 582 F.2d 378 (6th Cir. 1978), *cert. denied*, 440 U.S. 909 (1979).

76. 582 F.2d at 382.

77. 460 U.S. at 383.

78. *Id.* The first apparent use of the inconsistency test was in *Estate of Block v. Commissioner*, 39 B.T.A. 338, 340-41 (1939), *aff'd sub nom. Union Trust Co. v. Commissioner*, 111 F.2d 60 (7th Cir. 1940).

79. 460 U.S. at 383-84.

80. *Id.* at 381.

81. *Id.* at 383-84. A later event that is fundamentally inconsistent with the earlier deduction might also be an actual recovery of the type traditionally encountered in the tax benefit rule.

82. *Id.* at 383 n.15.

the building in year two, the tax benefit rule would not apply because fire is a normal business risk.⁸³ Conversion of the leased premises to personal use, on the other hand, would have been fundamentally inconsistent with the taxpayer's business, and would have invoked the tax benefit rule.⁸⁴ To determine whether a fundamentally inconsistent event occurred a court must analyze the purpose of the deduction in the light of the later event.⁸⁵ If the deduction occurred in the context of a nonrecognition provision, the Court observed that tension existed between nonrecognition and the tax benefit rule.⁸⁶ The Court could not articulate any general rule concerning whether the tax benefit rule would override a nonrecognition provision.⁸⁷ Rather, whether the nonrecognition provision prevails will depend upon the facts of the particular case.⁸⁸

In *Hillsboro National Bank* the Court reviewed the hazy legislative history of section 164(e),⁸⁹ which granted the bank authority to deduct the tax on the bank's stock. The Court believed that Congress enacted that section to ease the burden on banks, which historically paid those taxes.⁹⁰ Nothing in the legislative history indicated that Congress intended a later refund of the taxes to the bank's shareholders to affect the validity of the deduction.⁹¹ The Court therefore concluded that the act of payment was the significant event and that the later refund to the shareholders was not fundamentally inconsistent with the earlier deduction.⁹²

The Court analyzed the tax consequences to the bank assuming that Congress had never enacted section 164(e).⁹³ Absent that section, the bank could not have deducted the payment of the taxes because the taxes were not imposed on the bank, but on the shareholders. Moreover, the shareholders would have received a constructive distribution when the bank paid their tax obligation. If the bank had earnings and profits, the constructive distribution would have constituted a taxable dividend. The shareholders, however, would have been allowed an offsetting deduction for the tax payment. Without section 164(e), therefore, no tax consequences existed to either the bank or the shareholders. The bank did not receive a deduction; the shareholders received an income and deduction wash.⁹⁴ In contrast, under section 164(e) the transaction still constitutes a wash to the shareholders because they do not recognize income and they are not allowed a deduction.⁹⁵ With section 164(e), though, the bank may take a deduction.⁹⁶

83. *Id.* at 384-85.

84. *Id.* at 385.

85. *Id.*

86. *Id.*

87. *Id.* at 386.

88. *Id.*

89. I.R.C. § 164(e) (1982).

90. 460 U.S. at 393-95.

91. *Id.* at 394.

92. *Id.* at 394-95.

93. *Id.* at 392.

94. *Id.*

95. *Id.* at 392-93.

96. *Id.* at 393.

In *Bliss Dairy* the IRS argued that the dairy received a tax benefit when it expensed the cattle feed and during the next year distributed that same feed to the dairy's shareholders. The taxpayers, on the other hand, argued that the general nonrecognition rule of section 336,⁹⁷ rather than the tax benefit rule, controlled the tax effect. Lower courts divided on the need for an actual recovery to invoke the tax benefit rule in section 336 cases. The Ninth Circuit required a recovery.⁹⁸ In contrast, the Sixth Circuit theorized that since the tax benefit rule applied to section 337⁹⁹ transactions, then not to impose the rule in section 336 transactions would be inequitable.¹⁰⁰

In *Bliss Dairy* the Supreme Court examined section 162(a),¹⁰¹ which permits deduction of the ordinary and necessary business expenses of carrying on a trade or business. The Court believed that Congress granted the ordinary and necessary business expense deduction because the taxpayer's business would consume the item within the tax year.¹⁰² The conversion of that item to personal use, therefore, was inconsistent with the earlier business deduction.¹⁰³ The Court concluded that the tax benefit rule mandated that a taxpayer include a converted expense item in income because the conversion was fundamentally inconsistent with the purpose of the prior deduction.¹⁰⁴ Thus, *Bliss Dairy's* distribution of the previously deducted cattle feed was inconsistent with the prior deduction of that feed.

The Court next inquired whether the section 336 nonrecognition rule protected *Bliss Dairy* from the tax benefit rule.¹⁰⁵ Section 336 provides that a corporation will not recognize income because of distributions of appreciated property in liquidation. The Court concluded that Congress's purpose in enacting section 336 was to prevent recognition of unrealized appreciation in an arm's-length transfer to an unrelated party.¹⁰⁶ The Court also noted that exceptions existed to section 336's nonrecognition treatment for depreciation recapture and assignment of income.¹⁰⁷ Moreover, the Court observed that an exception from analogous section 337 existed in favor of the tax benefit rule.¹⁰⁸ The Court reasoned that a similar exception from section 336 should exist as well.¹⁰⁹ Accordingly, a corporation should recognize income upon distribution of previously expensed items. *Bliss Dairy* therefore was taxed on the feed on hand at the moment of liquidation.¹¹⁰

97. I.R.C. § 336 (1982).

98. *Commissioner v. South Lake Farms, Inc.*, 324 F.2d 837, 839-40 (9th Cir. 1963).

99. I.R.C. § 337 (1982). Section 337 provides that a corporation in the process of liquidating will not recognize income when selling the corporation's business assets. *Id.*

100. *Tennessee-Carolina Transp., Inc. v. Commissioner*, 582 F.2d 378, 381-82 (6th Cir. 1978), *cert. denied*, 440 U.S. 909 (1979).

101. I.R.C. § 162(a) (1982).

102. 460 U.S. at 395.

103. *Id.* at 396.

104. *Id.* at 395.

105. *Id.* at 397.

106. *Id.* at 398.

107. *Id.*

108. *Id.* at 401.

109. *Id.* at 402.

110. *Id.*

The Court did not believe that addressing the proper amount of income to Bliss Dairy was necessary.¹¹¹ The Court ruled that the income to Bliss Dairy was the cattle feed on hand at liquidation.¹¹² The Court did not answer the question of whether the income to Bliss Dairy should have been the lesser of the amount Bliss Dairy previously deducted or the cattle feed's basis to the shareholders.

Justice Stevens dissented in *Bliss Dairy* because Bliss Dairy had not received a recovery.¹¹³ Justice Stevens read prior cases to require a recovery and stated that inconsistency, without more, was an insufficient basis for future taxation.¹¹⁴ He believed that a court should examine subsequent events only to determine whether a recovery had occurred and not to review the premises for the prior deduction.¹¹⁵ Justice Stevens also expressed concern over the Court's broadening of the tax benefit rule and consequent enlargement of the IRS's powers.¹¹⁶ He believed this expansion would produce controversy and litigation.¹¹⁷

B. *The Meaning of Hillsboro National Bank and Bliss Dairy*

The central issue in *Hillsboro National Bank v. Commissioner* was the definition of the tax benefit rule's scope.¹¹⁸ The fundamentally inconsistent test gives the IRS greater power than the old tax benefit rule. The search for the premise of the prior deduction required by the new test virtually guarantees that the IRS can apply its own form of subjectivity to the transaction. Tax advisors will have to make difficult decisions on tax reporting because of the almost impossible task of distinguishing mere inconsistencies from fundamental inconsistencies.¹¹⁹ This interpretative difficulty can only enhance the

111. *Id.* at 403.

112. *Id.*

113. *See id.* at 421 (Stevens, J., dissenting). Also dissenting were Justices Blackmun, Brennan, and Marshall.

114. *Id.* at 405-12.

115. *See id.* at 418.

116. *Id.* at 404.

117. *Id.* at 416; *see also* Yin, *Supreme Court's Tax Benefit Rule Decision: Unanswered Questions Invite Future Litigation*, 59 J. TAX'N 130, 131 (1983):

[T]he various broadbrush tests articulated by the Court have potentially far-reaching consequences that will provide vexing problems for both tax practitioners and the IRS and will likely spawn additional litigation in the area. Rather than providing a blissful end to the tax benefit rule controversy in these corporate contexts, the Court may have reopened a number of issues that were heretofore thought settled.

118. Blum, *The Role of the Supreme Court in Federal Income Tax Controversies—Hillsboro National Bank and Bliss Dairy, Inc.*, 61 TAXES 363, 365 (1983).

119. Professor Blum focuses on the key test created by the Court and concludes: "[T]he language about fundamental and lesser inconsistencies [is] bound to cause puzzlement among tax advisors." Blum, *supra* note 118, at 366. Professor Martin Ginsburg, in his unique way, describes the Court's "newly crafted analytic tool" as "an invitation to unending litigation and the virtual assurance that we will not develop a coherent body of case law interpreting the tax benefit rule." Address by Professor Martin D. Ginsburg, *Decisions on Appeal: The Developing Role of the CAFC*, The First Annual Judicial Conference of the United States Courts of Appeals for the Federal Circuit (May 20, 1983), *reprinted in* 100 F.R.D. 499, 564, 570 (1984). Professor Ginsburg also experiences particular difficulty with the fundamentally inconsistent test: "I am barely able to identify an inconsistency when it grabs me by the lapels. I am

IRS's power.

The distinction between mere inconsistencies and fundamental inconsistencies literally requires an examination of whether, if the later event had occurred in the tax year of the original deduction, the deduction would have been disallowed. If so, upon the happening of the later event, the taxpayer should recognize income. Under the facts of *Bliss Dairy*, distribution of the cattle feed in liquidation, if it had occurred in the year of payment, would have prevented the deduction for the feed. An important distinguishing factor between *Hillsboro National Bank* and *Bliss Dairy* is the degree of control and participation over the subsequent inconsistent event. In *Hillsboro National Bank* the bank could not control the subsequent property tax refund, although in *Bliss Dairy* the dairy planned the liquidation. The Court's single example of the new tax benefit rule's application draws the same distinction. The fire in the subsequent year was outside the taxpayer's control and therefore not inconsistent with the preceding year's rent deduction. Personal use of the leased premises, however, would trigger tax benefit recapture since the determining factor was the taxpayer's decision to convert the property to personal use.

Another uncertainty following from *Bliss Dairy* involves the relationship of the tax benefit rule to the Code's nonrecognition provisions. The Court declined to resolve the tension between the tax benefit rule and the nonrecognition provisions with a blanket rule.¹²⁰ Instead, the Court determined that a court must focus on the particular Code provisions at issue in the case.¹²¹ This refusal to adopt a general rule is a further invitation to uncertainty.¹²²

When a nonrecognition transaction provides for total nonrecognition of gain and either carryover or substituted basis, then the reasons for applying the tax benefit rule are unclear. The inherent gain in the transferred property is preserved, and the tax on that gain is deferred, not avoided. In *Bliss Dairy* the Court did not seem concerned with the tax treatment of the assets distributed to the shareholders. The Court believed that distribution in liquidation was inconsistent with the feed deduction, which was allowed on the premise that the dairy would consume the feed. The Court did not consider the shareholder basis in the distributed feed. If applying the tax benefit rule forecloses a double deduction, then applying the rule is perhaps justified. If no double deduction is possible, however, no reason exists why the tax benefit rule should be applied. The Court's analysis does not distinguish the situation in which a double deduction is likely from the situation in which such a possibility does not exist.

Another difficulty with *Hillsboro National Bank v. Commissioner* relates to footnote 20 of the majority opinion.¹²³ Footnote 20 hypothesizes on the application of the tax benefit rule to gifts and legacies of previously expensed

tragically unable to identify a fundamental inconsistency even though it bites me on the ankle. I strongly suspect I am not alone in this" *Id.*

120. 460 U.S. at 386.

121. *Id.*

122. Blum, *supra* note 118, at 367.

123. 360 U.S. at 386 n.20.

assets.¹²⁴ The problem with this footnote is that the footnote specifies gifts and legacies as future targets for the tax benefit rule,¹²⁵ but no one had previously considered that the tax benefit rule might apply in these settings. For the Court to raise the specter of gifts or death triggering the tax benefit rule is, at the least, adventuresome judicial decision-making.

IV. TRANSACTIONAL APPLICATIONS

A. *Relationship to Earlier Events*

The tax benefit rule will not always apply merely because some later event is fundamentally inconsistent with the earlier deduction. Rather, a nexus must exist between the later and earlier events. The IRS has indicated that a direct relationship must exist between the event that constitutes the loss and the event that constitutes the recovery.¹²⁶ For example, receiving money from a debtor on a second debt, after the taxpayer had previously written off the first debt as worthless, would not invoke the tax benefit rule if the money recovered were not part of the first debt.¹²⁷

B. *Nonrecognition Transactions and Carryover Basis*

A central issue in *Bliss Dairy* was whether the judicial tax benefit rule would override the statutory nonrecognition rule of section 336. The Supreme Court decided that section 336 was subordinate to the tax benefit rule.¹²⁸ A liquidating corporation, therefore, recognizes income upon liquidation and distribution of an expensed asset. Despite this ruling, the Court was unwilling to issue a universal rule to deal with all Code nonrecognition provisions.¹²⁹

124. The footnote states:

[T]he Government's position implies that an individual proprietor who makes a gift of an expensed asset must recognize the amount of the expense as income Similarly, the Government's view suggests the conclusion that one who dies and leaves an expensed asset to his heirs would, in his last return, recognize income in the amount of the earlier deduction. Our decision in the cases before us now, however, will not determine the outcome in these other situations; it will only demonstrate the proper analysis. Those cases will require consideration of the treatment of gifts and legacies as well as [depreciation recapture provisions], which are a partial codification of the tax benefit rule . . . and which exempt dispositions by gift and transfers at death from the operation of the general depreciation recapture rules.

Id.

125. Blum, *supra* note 118, at 369.

126. See Ltr. Rul. 8312057 (Dec. 20, 1982); see also *Allen v. Trust Co.*, 180 F.2d 527, 528 (5th Cir. 1950) (taxpayer not entitled to use tax benefit rule to exclude gain on sale of stock that he had previously accepted in part satisfaction of a bad debt, while writing off the remaining part as worthless, because stock sale was a separate transaction from the earlier acceptance).

127. *Sloan v. Commissioner*, 188 F.2d 254, 263 (6th Cir. 1951).

128. 460 U.S. at 402.

129. *Id.* at 386; see *Ballou Constr. Co. v. United States*, 85-1 U.S.T.C. (CCH) ¶ 9418 (D. Kan. 1985) (restoration of sand deposit into income by liquidating subsidiary; tax benefit rule overrides § 336); *Gorton v. Commissioner*, 49 TAX CT. MEM. DEC. (CCH) 612, 617-21 (1985) (previously expensed inventory distributed in liquidation restored into income to the extent of value of inventory).

The Code contains many tax benefit rules in the form of statutory recapture. Sections 1245¹³⁰ and 1250¹³¹ are obvious examples of codified tax benefit rules. Those sections require that a taxpayer recognize as ordinary income excess depreciation taken in prior years. The depreciation recapture sections indicate the extent to which those sections override the statutory nonrecognition rule. Those sections exclude the following from depreciation recapture: (1) transfers that are gifts;¹³² (2) transfers at death;¹³³ (3) transfers that are tax-free exchanges, except to the extent that the exchange involves boot;¹³⁴ and (4) transfers within certain Code sections that involve carryover basis, except to the extent that the taxpayer recognizes gain.¹³⁵ Similar rules cover investment tax credit recapture. Excluded from investment tax credit recapture are: (1) transfers at death; (2) transfers during most reorganizations; and (3) transfers during mere changes in the form of operating the business, so long as the property is retained in the business and the taxpayer retains a substantial interest in the business.¹³⁶

Other recapture rules that exempt gifts, transfers at death, and carryover basis transactions concern: (1) expensed intangible drilling costs;¹³⁷ (2) expensed mine exploration expenditures;¹³⁸ and (3) expensed soil and water conservation and land clearing expenditures preceding dispositions of farmland.¹³⁹ When the Revenue Act of 1962 added section 1245,¹⁴⁰ legislative motivation for excepting nonrecognition/carryover basis transactions from recapture was the belief that a tax-free transaction that involved carryover basis was not a transaction on which recapture should occur.¹⁴¹ Likewise, nonrecognition/carryover basis transactions, as well as gifts and transfers at death, are not the type of transactions on which the tax benefit rule should apply because these transactions are not fundamentally inconsistent with corresponding earlier deductions.

130. I.R.C. § 1245 (West 1982 & Supp. 1985).

131. *Id.* § 1250.

132. *Id.* §§ 1245(b)(1), 1250(d)(1) (1982).

133. *Id.* § 1245(b)(2), 1250(d)(2).

134. *Id.* §§ 1245(b)(4), 1250(d)(4). The exchange must be tax-free under either § 1031 (exchange of property held for productive use or investment) or § 1033 (involuntary conversion).

135. *Id.* §§ 1245(b)(3), 1250(d)(3). The transfer must be within either § 332, § 351, § 361, § 371(a), § 374(a), § 721, or § 731 to qualify for the exception.

136. *Id.* § 47(b).

137. Treas. Reg. § 1.1254-2 (1980).

138. I.R.C. § 617(d)(3) (1982).

139. Treas. Reg. § 1.1252-2 (1976); *see also* Treas. Reg. § 16A.1255-2 (1981) (temporary regulation) (exceptions from recapture of excluded cost-sharing payments received); H. CONF. REP. NO. 861, 98th Cong., 2d Sess. 895, *reprinted in* 1984 U.S. CODE CONG. & AD. NEWS 1445, 1583 (Treasury Department to provide exceptions from recapture of certain excluded rental income similar to exceptions in §§ 1245 & 1250).

140. Revenue Act of 1962, Pub. L. No. 87-834, 76 Stat. 960, 1032-36.

141. H.R. REP. NO. 1447, 87th Cong., 2d Sess. A109-12 (1962); S. REP. NO. 1881, 87th Cong., 2d Sess. 97-99, *reprinted in* 1962 U.S. CODE CONG. & AD. NEWS 3304, 3398-3404.

V. ORGANIZATIONAL APPLICATIONS

A. Partnerships

In a partnership context, the application of the tax benefit rule could occur at either the partnership or individual partner level. The regulations apply the rule to the partners, not to the partnership.¹⁴² Accordingly, if a partnership deducts an item when the partnership has income, but when none of the partners has sufficient income to allow the deduction to have a tax effect, then the partnership's later recovery of that item should not be taxed, despite the reduction of partnership level income. A contrary result was reached, however, under an ancient case.¹⁴³ Logic and at least one leading source, though, favor the regulation's approach.¹⁴⁴

B. Multiple Taxpayers

When more than one taxpayer deducts or recovers an item, application of the tax benefit rule becomes difficult. Courts established early that a taxpayer claiming that no tax benefit resulted from an earlier deduction must be the taxpayer that took the deduction.¹⁴⁵ A husband and wife who file a joint return in the year of the deduction are treated as a single taxpayer in the year of the recovery if they also file a joint return in that year.¹⁴⁶ If they file separate returns in the recovery year, however, the section 111 exclusion, if any, is divided between them on the basis of their contributions to the earlier tax benefit.¹⁴⁷ If the recovery year is a joint return year, but the deduction year was a year of separate returns, then the section 111 exclusion is based on the income of the spouse who deducted the recovered item in the earlier separate year.¹⁴⁸

C. Successors-in-Interest to the Taxpayer

Both the inclusionary and exclusionary parts of the tax benefit rule presuppose that the taxpayer taking the earlier deduction and recovering it later are one and the same. When the deduction and recovery occur to different taxpayers, application of the tax benefit rule is problematic. Section 381(c)(12) allows a taxpayer's successor-in-interest, in a transaction that section 381 governs, to succeed to the transferor corporation's right to recover "bad debts, prior taxes, or delinquency amounts previously deducted or

142. Treas. Reg. § 1.702-1(a)(8)(i) (1960).

143. *Haughey v. Commissioner*, 47 B.T.A. 1, 3-5 (1942).

144. 1 W. MCKEE, W. NELSON & R. WHITEMIRE, *FEDERAL TAXATION OF PARTNERSHIPS AND PARTNERS* ¶ 9.05[3][i] (1977).

145. *Plumb, The Tax Benefit Rule Today*, 57 HARV. L. REV. 129, 171 (1943) (citing *Michael Carpenter Co. v. Commissioner*, 47 B.T.A. 626 (1942), *aff'd on other grounds*, 136 F.2d 51 (7th Cir. 1943)).

146. This result follows because when a husband and wife file a joint return, each can take advantage of the losses of the other. *Plumb, supra* note 145, at 174 (citing *Taft v. Helvering*, 311 U.S. 195 (1940); *Helvering v. Janney*, 311 U.S. 189 (1940)).

147. *Plumb, supra* note 145, at 174.

148. *See id.*

credited.”¹⁴⁹ The regulations extend the reach of this statute to “all other losses, expenditures and accruals” of the transferor.¹⁵⁰ The section 111 exclusion, therefore, extends to the successor-in-interest in transactions governed by section 381.

In a bankruptcy setting the trustee of the bankrupt estate is a successor-in-interest of sorts to the debtor. If the trustee experiences an event fundamentally inconsistent with an earlier deduction of the debtor, application of the tax benefit rule is not analytically tidy. When the bankruptcy estate is a separate taxpayer and legal entity, the tax benefit rule perhaps should not apply. When the bankruptcy estate and debtor are not separate entities, however, a court could logically apply the rule.

D. Incorporation

A section 351¹⁵¹ transfer of assets is generally a nontaxable transaction to the transferor. The shareholder has merely transferred property to a controlled corporation and has not changed the form of the investment. Incorporation is not the moment for taxing the inherent gain in the assets transferred to the corporation, especially since the corporation's basis in the transferred assets is the same as the transferor's. When the taxpayer incorporates a going business the transferred assets are usually ordinary income items, such as inventory, accounts receivable, previously deducted materials and supplies, and contract rights. A court in this situation may subordinate section 351 to certain judicial doctrines, such as the assignment of income doctrine.¹⁵² One of these judicial doctrines is the tax benefit rule.

The Supreme Court confronted application of the tax benefit rule in the context of an incorporation in *Nash v. United States*.¹⁵³ The case involved incorporation of a partnership that previously had deducted bad debt reserve additions. Applying the tax benefit rule, the IRS restored into the partnership's income the prior bad debt reserve deduction. The IRS conceded that no recovery existed since the transfer of property was to the corporation and not the partnership. The IRS nevertheless urged the Court to adopt the “end of need” theory when applying the tax benefit rule. According to this theory, a court should not permit a taxpayer to retain the tax benefit of a deduction if later events demonstrated that the taxpayer was no longer enti-

149. I.R.C. § 381(c)(12) (1982). Section 381 governs § 332 liquidations and certain transfers in connection with § 368(a)(1) type A, C, D, F, or G reorganizations. *Id.* § 381(a).

150. Treas. Reg. § 1.381(c)(12)-1(a)(2) (1961). On two occasions the Tax Court has addressed a successor-in-interest's use of the tax benefit rule. In *Erie County United Bank v. Commissioner*, 21 T.C. 636, 641-43 (1954), a predecessor corporation did not deduct bad debts, and the predecessor's basis for those bad debts was carried over to the successor. When the successor's subsequent recovery did not exceed that basis the recovery was not taxable income to the successor. *Id.* at 646. In *Ridge Realization Corp. v. Commissioner*, 45 T.C. 508, 523-26 (1966), the court permitted the successor to utilize § 111 when the predecessor had deducted losses, but had not received any tax benefit from them.

151. I.R.C. § 351 (1982).

152. B. BITTKER & J. EUSTICE, *FEDERAL INCOME TAXATION OF CORPORATIONS AND SHAREHOLDERS* ¶ 3.17, at 3-67 (4th ed. 1979).

153. 398 U.S. 1 (1970).

tled to that tax benefit.¹⁵⁴ A court should not, therefore, limit application of the tax benefit rule to cases in which there has been a recovery.¹⁵⁵ The Court did not apply the tax benefit rule, however, because no event justified the rule's application.¹⁵⁶ The incorporation and attendant transfer of the bad debt reserve to the corporation did not enrich the taxpayer. The value of the stock that the taxpayer received was based upon the value of the receivables less the bad debt reserve. The taxpayer, therefore, realized no economic gain.

The Court, however, did not foreclose application of the tax benefit rule to section 351 transactions. The Court indicated that the tax benefit rule would apply to section 351 transfers to the extent that an economic recapture of the prior deductions existed.¹⁵⁷ Section 351 transactions are, therefore, potentially subject to the tax benefit rule if the stock received is exchanged for assets having a short life.¹⁵⁸

Following *Hillsboro National Bank v. Commissioner*, one can argue that the policy implicit in statutory depreciation recapture of not imposing a tax in carryover basis situations should preclude application of the tax benefit rules to incorporations.¹⁵⁹ The continuation of the inherent gain to the transferee corporation should prevent application of the tax benefit rule until the corporation's disposition of the property. The tax benefit rule may have some vitality, though, if the taxpayer contributes previously expensed assets

154. Brief for the United States at 7-14, *Nash v. United States*, 398 U.S. 1 (1970). The "end of need" analysis derives from a series of Tax Court cases that provided that a taxpayer must restore into income any balance in the bad debt reserve in the year when the need for the reserve ceased. *Arcadia Sav. & Loan Ass'n v. Commissioner*, 34 T.C. 679, 681-82 (1960), *aff'd*, 300 F.2d 247 (9th Cir. 1962); *West Seattle Nat'l Bank v. Commissioner*, 33 T.C. 341, 343 (1959), *aff'd*, 288 F.2d 47 (9th Cir. 1961); *Geyer, Cornell & Newell, Inc. v. Commissioner*, 6 T.C. 96, 100 (1946). The "end of need" argument was also part of the IRS's aggressive use of the tax benefit rule in the early 1960s. *Rev. Rul. 62-128*, 1962-2 C.B. 139 (upon incorporation of a sole proprietorship involving transfer of a bad debt reserve, the amount of the reserve is ordinary income to the transferor because the transferor no longer needed the reserve), *revoked*, *Rev. Rul. 78-280*, 1978-2 C.B. 139.

Both the Supreme Court and the Ninth Circuit, however, rejected the IRS argument raised in that revenue ruling. In *Estate of Schmidt v. Commissioner*, 355 F.2d 111, 113 & n.7 (9th Cir. 1966), the Ninth Circuit concluded that the cases cited in *Rev. Rul. 62-128*, 1962-2 C.B. 139, *revoked*, *Rev. Rul. 78-280*, 1978-2 C.B. 139, did not support the "end of need" argument because the taxpayers in those cases actually collected the amounts previously reserved. In *Nash v. United States*, 398 U.S. 1 (1970), the Supreme Court decided that incorporation of a partnership with attendant transfer of a bad debt reserve to the corporation did not enrich the taxpayer because the corporation issued the stock based upon the value of the receivables less the bad debt reserve. *Id.* at 4-5. No event, therefore, justified applying the tax benefit rule. *Id.* Although the Court agreed that incorporation ended the need for the bad debt reserve, the Court refused to equate the end of that need with a recovery for purposes of the tax benefit rule. *Id.* at 3-4. Moreover, *Hillsboro National Bank* and *Bliss Dairy* demonstrate that the "end of need" analysis is inadequate for determining application of the tax benefit rule. At the very least, the "fundamentally inconsistent" test has supplanted the "end of need" analysis.

155. *Id.*

156. 398 U.S. at 4-5.

157. See *id.*; see also O'Hare, *Statutory Nonrecognition of Income and the Overriding Principle of the Tax Benefit Rule in the Taxation of Corporations and Shareholders*, 27 TAX L. REV. 215, 245 (1972) (discussing application of tax benefit rule to corporate liquidations).

158. B. BITTKER & J. EUSTICE, *supra* note 152, ¶ 3.17, at 3-68 to -69.

159. See *Rev. Rul. 71-569*, 1971-2 C.B. 314.

to the newly formed corporation. For example, if the taxpayer contributes assets on which he previously took deductions, the transfer may be fundamentally inconsistent with the earlier deduction, much like the distribution of cattle feed in *Bliss Dairy*.

E. Change of Tax Status

Some taxpayers receive a tax allowance merely because they qualify for a certain tax status. The new tax benefit rule has potential application if they lose this preferred tax status.¹⁶⁰ These tax allowances can take the form of enhanced deductions or exemptions. For example, section 593¹⁶¹ permits savings and loan associations to take a greater bad debt reserve deduction than most ordinary businesses. Most businesses are allowed to add to their bad debt reserve only if justified by their actual loss experience.¹⁶² Certain savings and loan associations, on the other hand, may qualify for special bad debt reserve deductions equal to forty percent of taxable income.¹⁶³ A novel, if not explosive, application of the tax benefit rule to a change of special tax status might occur when a previously qualified savings and loan association fails to qualify. If a court applied the tax benefit rule, the savings and loan association would have to take back into income the excess bad debt reserve deduction previously allowed.

For the tax benefit rule to cause recapture of a disqualified savings and loan association's enlarged bad debt reserve deduction, a twofold analysis must be considered. First, one might ask whether a court would allow a deduction for the special addition to the bad debt reserve in the same year that loss of the qualified status occurred. The answer is clearly no. Second, one must determine whether the enhanced bad debt deduction is premised upon the special tax status of being a savings and loan association, so that loss of that tax-favored position would be fundamentally inconsistent with the enhanced deduction. On this second point, a court must closely examine the legislative history of section 593 to discern whether the premise for allowing the deduction is the tax status of the savings and loan association or merely the act of making real estate home loans.

Since 1952, thrift institutions have been subject to the regular corporate tax.¹⁶⁴ The enlarged deduction for additions to bad debt reserves, however,

160. For example, a grandparent may claim a dependency exemption by paying college tuition for a grandchild. If the college later refunds some of the tuition, the grandparent would not qualify for the dependency exemption based upon the net amount paid. Questions can also arise concerning taxpayers filing as a surviving spouse or head of household when they later discover that they did not qualify for that status. See 1 B. BITTKER, *supra* note 5, ¶ 5.7.2, at 5-53 n.35. Moreover, a trust's gain or loss of grantor trust status might trigger recapture.

161. I.R.C. § 593 (1982).

162. Although I.R.C. § 166(c) (1982) allows most businesses to use the reserve method of accounting for bad debts, ordinarily these businesses are only allowed a deduction to the extent justified by their actual loss experience. See Treas. Reg. § 1.166-4(b) (1960).

163. I.R.C. § 593(b)(2)(A) (1982).

164. Until 1951, savings and loan associations were exempt from federal income tax. In 1951, Congress imposed a tax on savings and loan associations for the first time because income is added to their reserves and undivided profits. "The fact that it is retained for the benefit of the members makes it analogous to the income retained by an ordinary taxable

has allowed thrift institutions to pay a lower rate of tax than most ordinary businesses.¹⁶⁵ Administrative commentary concerning section 593 suggests that the enhanced bad debt reserve deduction afforded savings and loan association is because of their special status as savings and loan associations, not because these organizations make home mortgage loans.¹⁶⁶ The loss of the qualified savings and loan association status, therefore, would be fundamentally inconsistent with the earlier enhanced bad debt reserve deduction. Accordingly, a court should require a disqualified savings and loan to recapture the enhanced part of the previous bad debt deductions.

VI. MISCELLANEOUS APPLICATIONS

A. Ordinary Expenses

The IRS has indicated that the tax benefit rule does not apply to ordinary business expenses previously deducted, even if the deduction resulted in a tax benefit.¹⁶⁷ Excluded from this rule, however, are prepayments and ordinary expenses that create transferable assets.¹⁶⁸ The pertinent rulings involved liquidations of insurance companies. The expenses in question include brokers' commissions, salaries, directors' fees, printing and stationery, sales commissions, telephone costs, and legal and accounting fees. The IRS concluded that these expenses did not represent unconsumed assets or

corporation for the benefit of its stockholders." S. REP. NO. 781, 82d Cong., 1st Sess. 26-29, *reprinted in* 1951 U.S. CODE CONG. & AD. NEWS 1969, 1994-97.

165. During the consideration of the Tax Reform Act of 1969, the Treasury Department candidly admitted that to call the special tax treatment afforded to savings and loan associations and other financial institutions "bad debt reserve provisions" was misleading:

In substance, the present bad debt reserve provisions for commercial banks, mutual savings banks and savings and loan associations are misnomers, and to a large degree are merely techniques for lowering the tax burdens of these institutions. This tax reduction intent is quite obvious in the case of the two latter types of institutions where the lower effective tax rate is the result of the law itself. . . . Congress desired to continue to provide some preferential tax treatment to these institutions . . . through the bad debt reserve deduction. The Congress presumably was influenced by . . . (1) the use of the . . . institutions by small savers, and (2) the emphasis on home mortgage loans in the institutions' lending policies. Also . . . a factor was the . . . view . . . that a catastrophe type reserve was needed because of widespread mortgage defaults in the 1930's.

Treasury Department Studies and Proposals 466-67, *reprinted in* TAX MGMT. (BNA)—PRIMARY SOURCES I, 593(b).13 (1971).

166. When Congress passed the Tax Reform Act of 1969 the Treasury Department expressed its preference that the taxation policy of savings and loans not be institutionally based. The Treasury Department thought that the tax law could promote mortgage lending and residential construction by tying tax subsidies to the loan itself and not to the institution. According to the Treasury Department's analysis, "[t]his would encourage commercial banks, which do not now get the subsidy, to make a lot more mortgage loans than they have been making in the past." Statement of The Honorable Charles E. Walker, Undersecretary of the Treasury, before the Senate Finance Committee 755-56, *reprinted in* TAX MGMT. (BNA)—PRIMARY SOURCES I, 593(b).32-33 (1971). The Treasury had presented an alternate proposal that would have said to savings and loans, mutual savings banks, or commercial banks that to "the extent it holds socially preferred type assets such as residential mortgage loans" than they would incur a reduced tax obligation. *Id.*

167. See Ltr. Rul. 8312057 (Dec. 20, 1982); Ltr. Rul. 8207068 (Nov. 20, 1981).

168. See Ltr. Rul. 8312057 (Dec. 20, 1982); Ltr. Rul. 8207068 (Nov. 20, 1981).

short-lived property on hand at the time of liquidation.¹⁶⁹ Accordingly, the tax benefit rule did not apply.

B. Research and Development Expenses

In a National Office Technical Advice Memorandum, the IRS applied the fundamentally inconsistent test of *Hillsboro National Bank v. Commissioner*.¹⁷⁰ The taxpayer was engaged in the manufacture and sale of chemicals and related products and incurred substantial expenditures for research and development. Generally, the taxpayer used the generated patents and confidential information in the business, but occasionally disposed of them. The taxpayer reported these sales as capital gains. The IRS characterized the proceeds from these sales as ordinary income to the extent that the taxpayer had previously deducted the research and development expenses attributable to them under section 174(a)(1).¹⁷¹

The IRS analogized the research and development expenses to section 162 expenses.¹⁷² The IRS concluded that if the taxpayer deducted the expenditures under section 162 in one year, the sale of the project in that year would have caused that deduction to be denied. Since sections 174(a)(1) and 162 are comparable, the later sales of patents and confidential information were fundamentally inconsistent with the earlier deductions under section 174(a)(1). The IRS cited Revenue Ruling 72-258¹⁷³ as authority.¹⁷⁴ That revenue ruling applied the tax benefit rule to the receipt of insurance proceeds following destruction of a development model. The taxpayer had developed a pilot model and deducted the cost of that model under section 174(a)(1). In the following year the model was destroyed. The IRS taxed the insurance proceeds as ordinary income to the extent of the previous deduction,¹⁷⁵ even though the IRS would normally have taxed the insurance proceeds as capital gains under section 1231.¹⁷⁶

C. Accrued Interest in Foreclosure

In a National Office Technical Advice Memorandum¹⁷⁷ the IRS held that on foreclosure of real property, the owner should recognize as ordinary income accrued and previously deducted, but unpaid, interest to the extent that such interest exceeds the fair market value of the property, less the outstanding mortgage. The IRS concluded that the taxpayer had not paid the

169. See Ltr. Rul. 8312057 (Dec. 20, 1982); Ltr. Rul. 8207068 (Nov. 20, 1981).

170. Ltr. Rul. 8409009 (Nov. 23, 1983).

171. *Id.*; see I.R.C. § 174(a) (1982).

172. I.R.C. § 162 (West 1978 & Supp. 1985).

173. 1972-2 C.B. 481. The IRS did not reach the question of whether the *Corn Products* doctrine applied. See *Corn Prod. Ref. Co. v. Commissioner*, 350 U.S. 46, 51-53 (1955) (gain from the sale of property integral to a business is taxed as ordinary gain). In G.C.M. 39162 (Mar. 2, 1984) the IRS applied the tax benefit rule rather than the *Corn Products* doctrine.

174. Ltr. Rul. 8409009 (Nov. 23, 1983).

175. Rev. Rul. 72-258, 1972-2 C.B. 481.

176. I.R.C. § 1231 (West 1982 & Supp. 1985).

177. Ltr. Rul. 8041017 (June 30, 1980).

previously deducted interest to that extent.¹⁷⁸ Under the *Hillsboro National Bank v. Commissioner* formulation of the tax benefit rule, no doubt should exist concerning the outcome. The original deduction was granted on the premise that the taxpayer would pay the interest. Subsequent foreclosure and failure to pay the interest is fundamentally inconsistent with that deduction.

D. Pension Contributions

The tax benefit rule does not apply when a corporation merges an overfunded and an underfunded employee benefit plan if the corporation funded the plans under the same insurance contract and the plans were part of the same plan document.¹⁷⁹ If the corporation funded the plans through a separate trust, however, the tax benefit rule requires recapture of the deduction pertaining to the overfunded plan.¹⁸⁰ In contrast, Revenue Ruling 73-528¹⁸¹ held that a transfer of funds from an overfunded plan to an underfunded plan triggered the tax benefit rule. The contributions to the overfunded plan were intended for the exclusive benefit of participants and beneficiaries of that plan and not for the purpose of funding another separate plan.

The IRS might also use the tax benefit rule to cause a corporation to recapture prior pension contribution deductions if the plan is terminated prematurely. The premise of the plan contributions is that they are for the benefit of employees in an ongoing plan. Upon plan termination, the IRS could argue that the plan was not permanent and the prior deductions should, therefore, be retroactively disallowed.¹⁸² The IRS's failure to win on the permanence argument, however, should still not prevent the IRS from attacking the plan termination as a fundamentally inconsistent event.

E. The Tax Benefit Rule and the Cancellation of Indebtedness Doctrine

Application of the tax benefit rule to the cancellation of indebtedness doctrine produces interesting, but questionable, results.¹⁸³ The cancellation of indebtedness doctrine appears to be the superior theory. Thus, as a general proposition, forgiveness of liability will constitute income whether or not the liability produced a tax benefit in an earlier year.¹⁸⁴ When debt forgiveness occurs in a contribution to capital context, such as when a shareholder forgives a debt the corporation owes him, the IRS has attempted with little success to use the tax benefit rule to tax the shareholder to the extent of the

178. *Id.*

179. Ltr. Rul. 8221087 (Feb. 25, 1982).

180. *Id.*

181. 1973-2 C.B. 13.

182. Rev. Rul. 69-25, 1969-1 C.B. 113. *But see* Lincoln Elec. Co. Employees' Profit Sharing Trust v. Commissioner, 190 F.2d 326, 330 (6th Cir. 1951).

183. 1 B. BITTKER, *supra* note 5, ¶ 6.4.5.

184. Putoma Corp. v. Commissioner, 66 T.C. 652, 663-64 (1976), *aff'd*, 601 F.2d 734 (5th Cir. 1979).

previously deducted interest on the debt.¹⁸⁵

VII. MEASURING THE TAX BENEFIT

A substantial uncertainty in the application of the tax benefit rule is the amount of income to be recognized upon the later recapture of an earlier deduction, allowance, or credit. Justice Stevens dissented sharply in *Bliss Dairy*, partly because the majority failed to answer this question.¹⁸⁶ Justice Stevens perceived that the majority made the following inconsistent statements on the proper amount of recaptured income: (1) recaptured income should equal the amount of the earlier deduction;¹⁸⁷ (2) recaptured income should equal the amount of the sale proceeds when a later sale is the inconsistent subsequent event;¹⁸⁸ and (3) recaptured income should be less than the earlier deduction if the item's fair market value at the time of the later event has decreased.¹⁸⁹ The majority's reply to Justice Stevens's criticism was simply that they did not attempt to resolve the question of the appropriate amount of recapture.¹⁹⁰ The answer to this important question, therefore, must be left to future litigation.

VIII. CONCLUSION

The Supreme Court in *Hillsboro National Bank v. Commissioner* has taken the tax benefit rule significantly farther along the path of resolving transactional inequities arising out of the annual accounting concept. The tax benefit rule has now moved away from the position of a minor policing role and towards the position of a major IRS enforcement tool, away from mere incidental occurrence in the lives of taxpayers and towards an omnipresence in most tax sensitive transactions, away from relative certainty and towards greater ambiguity. The tax benefit rule has broken from the past, so much so as to be almost unrecognizable from its early beginnings. The tax benefit rule is now a judicial rule; its future can only be tested and defined through future litigation. So grows the common law.¹⁹¹

185. 66 T.C. at 665-68.

186. 460 U.S. at 419-20 (Stevens, J., dissenting) ("The Court's opinion also leaves unclear the amount of income that is realized in the year in which the fundamentally inconsistent event occurs.").

187. *Id.* at 419 (Stevens, J., dissenting); see *id.* at 383. The majority stated that "[t]he proper increase in taxable income [to Bliss Dairy] is the portion of the cost of the grain attributable to the amount on hand at the time of liquidation." *Id.* at 403.

188. *Id.* at 419-20 (Stevens, J., dissenting); see *id.* at 395; see also *Rosen v. Commissioner*, 611 F.2d 942, 943-44 (1st Cir. 1980) (taxpayer realizes value of recovered asset determined at time of recovery).

189. 460 U.S. at 419 n.29 (Stevens, J., dissenting); see *id.* at 402 n.37; see also *Feld, The Tax Benefit of Bliss*, 62 B.U.L. REV. 443, 463-64 (1982) (discussing proper amount of recapture in *Bliss Dairy*).

190. 460 U.S. at 402 n.37.

191. I have borrowed this language from the concluding sentence of Bromberg, *Corporate Information: Texas Gulf Sulphur and Its Implications*, 22 Sw. L.J. 731, 754 (1968) (describing implications of another Supreme Court decision on common law).